UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

_____

JUSTIN DUFOE,
on behalf of himself and all
others similarly situated,

Plaintiffs,

V.

DRAFTKINGS INC., et al,

Defendants.

_____

Civil Action
No. 23-10524-DJC

December 19, 2023
2:58 p.m.

TRANSCRIPT OF MOTION HEARING

BEFORE THE HONORABLE DENISE J. CASPER

UNITED STATES DISTRICT COURT

JOHN J. MOAKLEY U.S. COURTHOUSE

1 COURTHOUSE WAY

BOSTON, MA 02210

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P R O C E E D I N G S

(The following proceedings were held in open court before the Honorable Denise J. Casper, United States District Judge, United States District Court, District of Massachusetts, at the John J. Moakley United States Courthouse, 1 Courthouse Way, Boston, Massachusetts, on December 19, 2023.)

THE CLERK: All rise.

(The Court entered the courtroom.)

THE CLERK: Court is in session. Please be seated.

Civil action 23-10524, Justin Dufoe v. DraftKings, et al.

Would counsel please state your name for the record.

MR. FATA: Good morning, your Honor. Anthony Fata on behalf of lead plaintiff and the putative class.

THE COURT: Good afternoon, counsel.

MR. EGAN: Good afternoon. Patrick Egan from Berman Tabacco, also on behalf of plaintiffs.

THE COURT: Good afternoon.

MR. BONGIORNO: Good afternoon, your Honor. Mike Bongiorno from WilmerHale for the defendants.

THE COURT: Good afternoon, counsel.

MR. FRAWLEY: Good afternoon, your Honor. Brian Frawley from Sullivan Cromwell for the defendants as well.

THE COURT: Good afternoon.

Counsel, I know we're here on the defendants' motion

to dismiss. I've had a chance to review the motion papers, opposition, reply, and attachments. I'm prepared to hear argument, counsel.

MR. FRAWLEY: Thank you, your Honor. Would you like me to stay here or use the podium?

THE COURT: Either way.

MR. FRAWLEY: Okay.

So, thank you.

Your Honor, again, for the record, it's Brian Frawley from Sullivan Cromwell for the defendants.

I think I'll start with the good news. I think that there's a basic agreement on what law governs here, and that the state law claims are governed by the federal standards and the prime issue that we're here to talk about today the application of how the Howey case from 80 years ago and its progeny to the transactions and assets at issue here, the non-fungible tokens of DraftKings.

The facts that are alleged here are fairly straightforward, and frankly, from defendants' perspective, as is perhaps evident from the papers, very few of them are actually relevant to this Court's decision.

DraftKings sold two categories of NFTs:

One, which I'll refer to for simplicity here as collectible NFTs or static or dynamic images of professional athletes associated with an NFT. There's virtually nothing in

the complaint about those -- that category of NFTs beyond indicating that they existed and were sold initially and through the Marketplace.

The second category of NFTs are Reinmaker NFTs, and we're going to come back to that in our discussion today. The bulk of the allegations in the complaint about what managerial efforts were undertaken, what profits were promised, or what enterprise exists all relate to the NFTs from the Reinmakers sports contest. And as we'll come to in some detail, those Reinmaker NFTs were effectively game pieces that were utilized in fantasy sports contests much like the DraftKings daily fantasy sports business that has existed for many years.

03:01

Before turning to the specific elements of the Howey test, I want to level set slightly -- and part of this is in the plaintiffs' arguments -- but what Howey talks about and what the Howey investment contract test is trying to establish is whether some other transaction is an equity-like interest in a common enterprise. It is a test that is trying to see whether or not what transaction is at issue looks and smells like an equity investment. And that's evident from the facts of Howey itself. There was an orange grove. There were strips of land, each of which had 48 trees on it, but the strips of land was just a measure of the investor's interest in the enterprise. The land was not what was being sold, it was just a convenient method of measuring an equity-like interest in an

03:01

enterprise. And we submit, your Honor, there's nothing of that sort alleged here.

In a similar vein, the plaintiffs point out repeatedly in their brief that what matters here and what the cases say is that substance governs over form. With that, the defendants agree. But the implications of that rule here is not the implications that are advocated for by the plaintiffs. It's the plaintiffs that are seeking to elevate form over function by making comparisons to cryptocurrency cases and declaring 03:03 that courts have found digital assets and cryptocurrencies to be securities. That's form.

The substance here is a collectible attached to an NFT and a Reinmaker game piece. That's the substance. The fact that there's an NFT involved in this at all has nothing to do with the substance. That's the form, not the substance. It is the plaintiffs that aren't embracing and addressing the substance.

Now, on the Howey test, the Howey test, as your Honor knows, has three elements.

03:03 Nobody's disputing the first element with the investment of money.

The second element concerns whether there's a common enterprise, which I'll come to in a second.

And the third element has two sort of subelements, it's whether the NFT purchasers were objectively induced by the

promoted to expect profits and whether those promised profits were to be derived from the managerial efforts of defendants.

As the 1st Circuit said in SG Ltd., horizontal commonality requires the pooling of assets from multiple investors in such a manner that all share in the profits and risks of the enterprise. We submit the facts here allege the opposite.

There is no pooling of investments here. What the plaintiffs say is not that the proceeds of the NFT sales were pooled in the enterprise, which they say is the Marketplace, they say they were pooled in DraftKings. They don't say that the NFT proceeds were used for the benefit of the Marketplace, they say they were used by DraftKings however it saw fit.

The 1st Circuit in SG Ltd. found pooling to be present where there was a, quote, an unambiguous representation to its clientele that the participants' funds were pooled into a single account and used to settle the participants' online transactions.

The funds here were pooled into a different entity, DraftKings, not the enterprise, to be used as DraftKings wishes, not for the benefit of NFT purchases. That doesn't meet the pooling test, and that alone is sufficient reason to grant the motion.

THE COURT: The pooling test for the purpose of the common enterprise or the pooling test for the purposes of the

expectation of profits?

MR. FRAWLEY: This, your Honor, is for the pooling test for the common enterprise.

And before I will hear the word "Dapper Labs" come out of my colleague's mouth many times when I turn over the podium here, the Dapper Labs case found pooling in that case because the court effectively found that Dapper's entire business was the enterprise. So by pooling the funds into Dapper Labs' business, they were pooled into the enterprise.

03:06 Plaintiffs argue vociferously here that the enterprise is not DraftKings, it's the Marketplace alone. By doing so, they destroy their pooling theory entirely.

A second element of the common enterprise test is that investors must face --

THE COURT: And why couldn't it be DraftKings? Are you saying because that's not how it's pled?

MR. FRAWLEY: The plaintiffs in their opposition, and perhaps in their complaint, although I think that's ambiguous, but their opposition makes clear that the enterprise is

03:06 Marketplace and not DraftKings, and they chastise us for having said otherwise in the motion.

So it is the plaintiffs' theory that the enterprise is the Marketplace, and it's their allegation that the money went to DraftKings, not to the Marketplace. And it's their allegation that DraftKings used the money as it wished, not for

the benefit of NFT purchasers.

A second element of commonality -- of the common enterprise is some version of horizontal or vertical commonality. Before we get to that, the plaintiffs in their brief argue that they've established broad vertical commonality, except in their complaint they plead that they must allege either strict vertical commonality or horizontal commonality. That's at paragraph 102 of the complaint. So their opposition is arguing for a theory that their complaint affirmatively disavows.

03:07

As to horizontal commonality, the 1st Circuit has said that commonality requires that the risks and the rewards of the investment be shared among the investors.

In the Revak v. SEC Realty case, the 2nd Circuit said that that commonality may not exist where an individual purchaser may make profits or sustain losses independent of the fortunes of other purchasers.

It is clear from the allegations of the complaint that these dissimilar NFTs can profit or lose on a daily basis independent of others.

03:08

I want to talk briefly about the two forms of NFTs here, because, again, the collectible NFTs, or what I'm referring to as collectible NFTs, are not addressed at all in the complaint on this topic. There isn't an allegation of profit potential, profit earnings, or that the investors in

these collectible NFTs had some common interest and common risk profile together.

As I alluded to earlier, all of the allegations that are specific to the NFTs concerned the Reinmaker NFTs.

We submit, your Honor, it's just not possible to argue that purchasers of Reinmaker NFTs have that sort of commonality. The whole point of the Reinmaker NFTs is for the purchasers to engage in battle against one another for profit, prizes. The purchasers compete against one another to buy and 03:09 acquire the NFTs, they compete against one another to form their preferred lineup for competitions, and then they compete against each other to win the prize. That's the opposite of commonality; it's competition, not commonality.

The last element of the horizontal commonality is that the common interests of the investors be tied to the enterprise. So the causal effect of the common winning and losing by the investors --

THE COURT: Counsel, I may be mixing up apples and oranges, I sort of remember some discussion about packs and the 03:10 value of the NFTs, and I'm not sure if that was in regards to the collectibles or the reignmaking.

MR. FRAWLEY: The entire concept of packs, like baseball cards, relates to the Reignmaker NFTs. The collectible NFTs are sold as you would sell any portrait or other collectible.

THE COURT: And isn't there some allegation about the value of those rising and falling separate from the competition between the reignmaking NFTs as game pieces, I guess?

MR. FRAWLEY: Well, there is an allusion to that in the complaint which is somewhat overwhelmed by the other allegation in the complaint that DraftKings told purchasers of the Reignmaker NFTs that they would lose value week after week throughout the season and that the utility of the Reignmaker NFTs was a function of the player, the length of the season left, and other factors relating to the game. But it was -- it's unambiguous in the complaint, and it's attachments -- it's paragraphs 113, 114 and 117 of the complaint, they're summarized at page 7 of our opening brief. But the -- DraftKings told the investors this the Reignmaker NFTs would decrease in value. And then the documents that the plaintiff attaches to his complaint has discussion among Reignmaker purchasers and commentators explaining how that would happen and why it would happen as the players become less valuable as the season wanes on.

So -- and there's no dispute about this in the opposition, that their complaint makes clear that the Reignmaker NFTs would lose value as the season went on. And that was what DraftKings told people when they sold them.

The last element of the common enterprise or horizontal commonality is that the common interests of the NFT

purchasers all be tied to the success or failure of the enterprise itself, that there be some causal connection between the risk and reward to the investors and the success and failure of the enterprise.

Your Honor, we submit that there's no allegation about -- anything about the success or failure of the Marketplace or even how one would measure the success or failure of the Marketplace. It's just an electronic platform by which one buys or sells NFTs. It's an eBay for NFTs for DraftKings.

03:13

But, beyond that, the plaintiffs say at 145 of their complaint that the NFT values peaked in either 2020 or 2021 and the values thereafter cratered.

Well, the Reignmaker game was introduced in the fall of 2022, and then more sports were added in 2023, that's at paragraphs 45 and 50 of the complaint. So the years when the Marketplace was succeeding, the plaintiffs say NFTs were failing. And again, that's the inverse of the commonality that they need to plead.

03:14

I touched briefly on vertical commonality before, and I won't spend a lot of time, the plaintiffs don't either. I will point out that the Dapper Labs case that the plaintiffs like to refer actually found vertical commonality absent. And the reason it's absent is quite simple, and that is that the vertical commonality or strict vertical commonality is absent

if an investor can profit when the promoter loses or vice versa.

And I know this begins to get a little confusing, your Honor, I was pretty confused about this, too, but the vertical commonality test, unlike some of the other ones that we talked about, is measuring the success of the promoter and investors, not the enterprise, the promoter here, presumably being DraftKings. And there isn't possibly an allegation of the complaint, nor could there be, that DraftKings', a company with three or four billion dollars in revenue, success or failure depends on whether or not NFT investors with $70 million of annual revenue make or lose any money. And in fact --

THE COURT: And can I decide that on the record here where I have to assume the allegations to be true?

MR. FRAWLEY: You do have to assume the well-pled allegations to be true, your Honor. But as we pointed out in our brief, much like the question with the Marketplace, the plaintiffs plead in their complaint DraftKings' earnings and derisively talk about the fact that DraftKings had lost a lot of money every year. But the year that DraftKings lost the least amount of money in the period that's covered by plaintiffs' allegation is the year that the plaintiffs say NFTs performed at their worst. So the year that DraftKings performed at its best, the NFTs performed at their worst. That's covered at pages 14 to 15 of our brief.

Turning now to the final element of the Howey test, like many of these, it has two elements. The first element is that the instrument must have been sold as a profit-making investment rather than an item to be used or consumed.

I point out that the complaint nowhere even contends that the plaintiff himself had any belief about the investment potential of the NFTs he purchased or that that belief was induced by DraftKings or that that was the reason for his purchases of NFTs.

03:17 Admittedly, this is an objective standard, but if the plaintiff can't muster that allegation on his own, one should be suspect of his contention.

But to qualify as an investment contract, investors must be motivated by a reasonable expectation and one that is fomented by the promoter, DraftKings, that the investment enables them to profit on the success of the enterprise.

Our brief goes through this in detail. The only reference to profit-making opportunities that is attributed to DraftKings in the complaint relates to the Reinmakers' prizes.

03:17 There is no allegation anywhere in the complaint that says DraftKings promised investment profits from any of these NFTs, not the collectible NFTs, not the Reignmaker NFTs.

THE COURT: And the reignmaking prizes were as a result of competition?

MR. FRAWLEY: Yes, your Honor.

THE COURT: As alleged? As alleged here?

MR. FRAWLEY: Well, I don't think the complaint alleges what caused the reignmaking prices to move, other than, as I alluded to, it agrees that the reignmaking prizes declined as the season progressed. In terms of what promises or representations were made by DraftKings, the only representations attributed to DraftKings about the profitability or profit potential of buying NFTs talks about Reignmaker contests and prizes.

03:18 But in their opposition, the plaintiffs say prize opportunities is not the profit that matters for their theory. They abandon any reliance on any profit-making theory that is tied to contest prizes, and by doing that, they abandon the only theory of investment motive that's attributed to DraftKings.

And there's -- there's two sort of counterbalancing issues associated with that. The plaintiffs need to establish that the profit-making potential was the inducement for the investment, but they disavow reliance on the only profit-making

03:19 potential that is in the complaint. And the complaint argues repeatedly that it was the contests and the prizes that was the motivation for people to invest in the NFTs and allege that that was the mechanism that DraftKings used to market and promote the NFTs. But, if that's the case, they're contending that the incentive that they need to show, the profit motive,

is not the profit motive they're relying on. So they're effectively disavowing the only theory that they offered in their complaint.

The last element of -- the last Howey prong is --

THE COURT: So, I guess, counsel, just on that last point, and maybe I misunderstood your argument in this regard. I thought part of the argument was that the contests and prizes, in the defendants' view, couldn't be the expectation of profits since it wasn't derived solely from the efforts of the promoter. Did I misunderstand that?

03:20

MR. FRAWLEY: No, your Honor, you fully understood our argument. And then, in the opposition to our motion, the plaintiffs said that you're all wrong, defendants, the prize-making potential is not the profits and we don't care about the prize-making potential, and that that was -- that was just some marketing gimmick that you were using to get additional investors.

THE COURT: Okay. Thank you.

MR. FRAWLEY: Just two more points on this last prong of Howey. The Supreme Court in the Forman case also held that where a purchaser is motivated by desire to use or consume the item purchased, the securities laws do not apply.

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As we argued in our papers, and again here this morning, clearly with regard to the Reignmaker NFTs, and I frankly don't believe the plaintiffs even dispute this, that

they are used in contest of skill for prizes. And that's what people bought them for. And for that reason, it's not capable of being the basis of a claim that it's a security under the Forman test.

And their reference to the Dapper Labs case on this point doesn't apply because what the Court in Dapper Labs said is that functionality or gamification, as the words were used there, didn't exist for the NFTs at issue in Dapper Labs.

Now, admittedly the Dapper Labs court found that what 03:22 I referred to as the collectible NFTs, there was a fact issue as to whether or not their primary motivation was one for utility or for investment. But, we submit, your Honor, that was the factual issues in Dapper Labs about an allegation where the defendants in that case very overtly marketed the NFTs as a means to raise money to support their blockchain and cryptocurrency. It's a different circumstance. We submit there is not allegations here about investors or purchasers buying collectible NFTs for investment value, at least not any attributed to DraftKings.

03:23 The last issue that -- raised by the Howey test, and I know there's a lot of issues I just raised here, but every one of them is a required element of the test, is that the profits have to be predicated on managerial efforts of the defendants.

As the plaintiffs describe it at page 23 of their brief, says that the purchasers have to have reasonably

expected their investment profits to come from the efforts of the promoter based on what purchasers were led to expect by the promoter.

The complaint here doesn't allege anywhere that DraftKings promised to undertake any managerial efforts for the benefit of NFT purchasers. In fact, they chide DraftKings and quote at length from the Terms of Use of the DraftKings NFT to say that the DraftKings had promised to do nothing, that they sold NFTs and didn't agree to do anything to benefit the NFT purchasers.

03:24

THE COURT: Well, don't they -- isn't it alleged that they operate the Marketplace?

MR. FRAWLEY: They operate the Marketplace, but they have -- they never made any promises that they would continue to do so or what services would be provided or how the Marketplace would benefit them or increase the value of their investment or increase the value of NFTs.

In the Rodriguez case, the 1st Circuit said that in the absence of any promise as to what managerial efforts would

03:24

be provided there was no pretense of a common enterprise managed by the promoter.

The 1st Circuit made clear that the bundle of rights -- again, this is an investment contract, the theory here is that the purchasers acquired some bundle of rights and those bundle of rights included a right that the promoter was

going to manage an enterprise for their benefit. And if there was no promise in that bundle of rights to provide the managerial efforts that were going to benefit the value of this supposed security, that there wasn't a security. And we think that applies here in spades.

So, in sum, on the Howey test, we don't believe there's any pooling because there was no unitary place where the proceeds were put for the benefit of NFT purchasers. Instead, the plaintiffs allege affirmatively, it was given to DraftKings to do with it as it wished. There's no common enterprise, and there was no promise of profits based on the managerial efforts of DraftKings.

03:25

The only other substantive issue raised in the motion to dismiss, your Honor, is the question of whether there is a viable implied cause of action for plaintiffs' third and fourth course of action under the Exchange Act.

There's not much to say on this, your Honor. The Supreme Court has basically ruled out implying causes of action since 15 years ago, and each time it addresses the issue, it rules it out further. The 1st Circuit has as well. So unless the statute unambiguously confers a right of action, there is none, and it's not the role of courts to imply one. And the cases that the plaintiffs cite, one from the District of Colorado and others from many decades ago, have no application in the 1st Circuit and have no application in light of more

03:26

recent Supreme Court and 1st Circuit decisions.

If the Court has no other questions, I appreciate your time.

THE COURT: Thank you. Thank you.

Counsel, I'll hear from you.

MR. FATA: Thank you, your Honor. Again, for the record, my name is Anthony Fata, and I represent lead plaintiff and the putative class. We appreciate you having us in today, your Honor.

03:27 I'd like to start with a few opening principles, the first of which is that on a motion to dismiss, the well-pled allegations of the complaint, which is to be viewed as a whole and not in isolated subparts, are to be taken as true. And here we have several examples where plaintiff has alleged something that the defendants are not acknowledging or recognizing.

And I will start with the point that plaintiffs alleged that the profit motive was the gamified version of some of the NFTs. And I believe I heard counsel say that our profit 03:27 motive alleged in the complaint were these games and that we did a switcheroo, if you will, in our response brief. And that simply, your Honor, is not the case.

If you look at paragraph 4 of our complaint, it states about -- starting with the second sentence, it states, In this case, lead plaintiff in the class bought DraftKings NFTs in

DraftKings' initial public offerings, called "drops," with the expectation that the DraftKings NFT platform would allow them to realize profits on their NFTs. The profits would come from the efforts of DraftKings to promote and operate the NFT platform. The profits would be realized when lead plaintiff and the class would sell their NFTs on the secondary market platform that DraftKings solely owned and managed.

THE COURT: And when you say "platform" there, are you referring to the Marketplace?

03:28 MR. FATA: Yes, your Honor, I'm --

THE COURT: When you said "secondary," is that different than the Marketplace or are they all the same Marketplace?

MR. FATA: In this instance, because DraftKings controlled every facet of the DraftKings Marketplace, which is what we allege is the enterprise, and because the NFTs could only be sold on the DraftKings Marketplace, that is the secondary market to which we're referring. And it's synonymous in this case, unlike other cases, where you have decentralized

03:29 digital assets. In this case, secondary market is the DraftKings Marketplace which is the enterprise at issue.

THE COURT: And as alleged, does that apply both to the collectibles and to the reignmaking?

MR. FATA: One hundred percent, your Honor. The collectibles and the Reinmakers are treated the same, as long

as they're DraftKings-issued NFTs. The -- and I will get into it in a moment, but this gamification process, as alleged in the complaint, was very limited and did not touch all investors.

The other fact -- there are other allegations, like paragraph 4, throughout the complaint regarding capital appreciation, your Honor, and secondary market sales. Paragraph 58 and Exhibit 5 at pages 4 to 5 discuss and allege the stock market-like feel of the secondary market for DraftKings Marketplace.

03:30

Paragraph 107 once again refers to capital appreciation.

I think, most importantly, your Honor, was the statement that defendants did not make any representations about open market profits and did not make any representations that there would be capital appreciation. And that is simply not true.

If you look at paragraph 112 of the complaint, there's a statement by the creator of the DraftKings Marketplace,

03:31

Mr. Kalish, who is one of the defendants, and an investor asked on a message board whether DraftKings NFT purchasers really owned the NFTs, or they referred to them as cards. And this is on August 29, 2022. Mr. Kalish responds: "You'll keep the open market profit" -- pause there -- "the open market profit of your cards. Don't worry. Maybe at worst this prevents you

from making more money, right?"

And so a fair inference from that statement is buy the rights to the NFT, sell it on the open market, the only open market, the secondary market is the DraftKings Marketplace, and pocket the profits. That is capital appreciation 101. It's what investors in the stock market do every day.

THE COURT: Meaning -- and again, when you say "open market," you mean the Marketplace?

MR. FATA: Correct.

03:32 THE COURT: Meaning, the allegation here is they only have value in the Marketplace.

MR. FATA: That is correct, because they can't be taken outside of the Marketplace, DraftKings prevents that.

If you look at other allegations in the complaint -- oh, I want to add that August 29, 2022 statement, that comes after the gamification, which the defendants want to turn this entire case into.

The NFTs were initially launched in August 2021. In February 2022, DraftKings says, We're going to start a gamified

03:32 version. In May 2022, they start selling the gamified NFTs. Then there's the summer and the preseason, et cetera, before the season starts. But on August 29, 2022, right before the season starts and right before the period of time in which defendants claim that they advertised to the world that these would reduce in value, Mr. Kalish, the president, tells an

investor, You will keep the open market profits.

The other issue, your Honor, is we've heard discussions about these -- the elements of the Howey test, an investment of money in a common enterprise with an expectation of profits to come from the managerial or entrepreneurial efforts of the promoter.

Throughout --

THE COURT: So, counsel, we're going to have to go back to this open market profit concept just so I'm clear on what you're alleging.

Are you saying that the allegation about Mr. Kalish's statement is, what, that -- how would an investor keep the open market profit? Just give me a hypothetical so I understand.

MR. FATA: Sure. So on August 1, 2022, they would buy an NFT.

THE COURT: And would it matter if it was collectible or --

MR. FATA: No.

THE COURT: -- reignmaking?

MR. FATA: No.

THE COURT: Okay.

MR. FATA: And if they saw the value of the NFT increasing, then they could sell it and pocket the difference in profits -- I'm sorry, profit the difference in purchase price and sale price, that equals profits, which equals capital

appreciation --

THE COURT: Selling it to someone else on the marketplace.

MR. FATA: Correct.

Your Honor, if it would help, if you look at Exhibit 5 to the complaint -- and I don't know if you have them handy, but --

THE COURT: I don't, but I'll go back, counsel.

MR. FATA: Exhibit 5 shows screenshots of NFTs for sale. And in those screenshots, what is shown is the -- for those NFTs the increasing value from one sale to the next when they were sold. And they even present something like a bid-ask spread that you see in the stock market where they say the best offer price is X and the best bid price is Y.

In the DraftKings Marketplace or exchange vernacular, I think they refer to both as offers. In the stock market, it would be a bid and an offer.

So we have these core three elements under Howey, and I'm going to get into the common enterprise and the expectation of profits components, but before I do, I think it's important to remember that both Howey, the Supreme Court's decision in 1946, and SG Ltd., the 1st Circuit's decision applying Howey -- by the way, applying it to an online game -- make clear that the three-prong test or the tripartite test, as the 1st Circuit refers to it, is flexible and adaptive to new innovations

conjured by securities promoters who are looking to obtain other people's money. And substance controls form and the focus is on the economic realities of the transaction.

And here we have DraftKings riding a wave of investor interest in cryptocurrencies and NFTs and capitalizing on that.

We allege throughout the complaint that the enterprise is the DraftKings Marketplace, which consists of both the initial drops, or initial public offerings, and the secondary market sales. Defendants want to spin this into we're alleging DraftKings as the enterprise or DraftKings itself has to be the enterprise. They don't cite any case that stands for that proposition. And under the Howey test, particularly its -- and under its application by the 1st Circuit, that would effectively allow, you know, a large, publicly traded, established company to sell unregistered securities and avoid the registration requirements because they would always have businesses or business lines, if you will, that are separate from the securities they're offering or the enterprise tethered to those securities. And that's simply not the law, your Honor.

Finally, both SG Ltd. and Howey make clear that you shouldn't impose additional requirements beyond the three basic requirements in the tripartite test. And several of defendants' arguments in their response brief are taking the facts of cases over time in the 70-plus years since Howey where

certain items were present and treating those as if they are -- treating those as if they are elements.

So defendants challenge the common enterprise and the expectation of profits elements, and in doing so they swim against the currents established by the Supreme Court's decision in SEC v. Howey, the 1st Circuit's opinion in SEC v. SG Ltd., as well as Dapper Labs -- I finally said it after several minutes of argument -- as well as Dapper Labs and the initial coin offering cases. All of these cases recognize the flexible approach of the investment contract test.

03:38

Turning first to the common enterprise, we agree with defendants that the 1st Circuit has recognized that common enterprise may be established with horizontal commonality, and it's expressly reserved judgment on whether one or both forms of vertical commonality suffice.

This Court need not reach the issue of whether vertical commonality applies because we satisfy the test for horizontal commonality. It requires two components: Number one, the pooling of assets from multiple investors; and number

03:39

two, that all investors share in the profits and risks of the enterprise.

What does pooling of assets mean? It means that investors' monies accumulated into a single enterprise. The money is invested into the enterprise and used to improve the ecosystem.

I believe I heard counsel say that the complaint does not allege that the money that DraftKings Marketplace raised from selling NFTs in the initial drops or initial public offerings and the money that it raised from its commissions were used to develop or improve the DraftKings Marketplace, the enterprise. But, again, our complaint alleges the opposite. In paragraph 40, we allege that DraftKings made an initial modest investment to get the DraftKings Marketplace going, to tout it; and then in paragraphs 23 and 24, we allege that DraftKings used the money from the NFT sales to develop the DraftKings Marketplace.

Defendants may argue that DraftKings could have used the money for other purposes as well. This is no different than any promoter of securities taking money into the enterprise and using it for their own purposes, whether it's to buy a second home or an island.

That DraftKings may have used some of the proceeds -- which is not alleged in the complaint -- while it may have used some of the proceeds for other business operations does not control the outcome in this case.

So in August 2021, DraftKings launches the Marketplace and says that it will be selling NFTs in initial drops, and further, that it will be setting up the secondary Marketplace, the DrafKings Marketplace for the resale of NFTs.

The enterprise, an ecosystem, were given a name, the

DrafKings Marketplace. And from August 2021 onward, investors paid DraftKings for the NFTs sold in the initial public offerings, and all secondary market sales went through DraftKings and it kept it's 5 to 15 percent commission. All this money from the initial drops and the commissions was paid to DraftKings, one entity.

DraftKings controlled every aspect of the ecosystem. It picked which NFTs would be the subject of initial offerings, and it picked which NFTs could be sold on the DrafKings Marketplace.

DraftKings mandated that its NFTs be resold only on the DrafKings Marketplace, could not be sold on third-party platforms.

DraftKings retained exchange-like commissions, 5 percent or more of the sale price occurring in the secondary market exchange that it created.

It used the proceeds of the initial offerings in secondary market exchanges to further develop the DrafKings Marketplace ecosystem.

Importantly, DraftKings retained all of the NFTs that it sold or that were traded between investors. It kept those for itself in its own crypto wallet on the Polygon Blockchain.

This is not a situation like Bitcoin where investors keep the asset in their own wallets or in a variety of, you know, brokers' wallets. DraftKings is, as far as the public is

concerned and as far as the investors are concerned, the only owner of record for the DraftKings NFTs. So what the investors are really trading are the limited rights that are alleged in the complaint: the right to view the DraftKings NFT on their DrafKings Marketplace account page, the right to sell those DraftKings NFTs to another DraftKings user who's registered an account on the DrafKings Marketplace, and I'll get into it in a little bit. They could also use them, some, perhaps, should they have a sufficient number for the promotions that DraftKings started to gin up further interest in the Marketplace, and that's the gamification.

03:43

All of the money went to one place, and the fruits of that money are reflected in one crypto wallet. And that, your Honor, satisfies the pooling of assets from multiple investors, the first component of horizontal commonality.

The next component of horizontal commonality is the sharing of --

THE COURT: So, I guess -- so maybe you're getting to this now, but is it sufficient that -- and I'm assuming it's --

03:44

that you're relying on Dapper Labs for this -- but is it sufficient that the money is going to this ecosystem as opposed to some suggestion that there's going to be pro rata distribution of money across the enterprise? Do you understand my point?

MR. FATA: I understand your point, your Honor.

That is correct. There's no requirement in the Howey test that there be pro rata distribution across all investors in the enterprise. They can have varying profits, some can have losses, some can have gains, and pro rata distribution is not required.

Dapper Labs is one case which expressly held that, and in doing so it reviewed the 1st Circuit's opinion in SG Ltd., and it said -- the 1st Circuit -- Judge Marrero held the 1st Circuit didn't require pro rata profit distribution, instead, pro rata distribution just happened to be a component of the investment scheme there, but it wasn't a rule, it's not a requirement. And if -- if the Court considers the other ISO cases, initial coin offering cases, those do not require pro rata distribution either.

And there have been -- even before the cryptocurrency wave, there have been a number of investment contract cases where investment contracts were found even though the investors did not receive the same level or degree of profits or did not receive common stock or anything resembling common stock.

If you look at the Supreme Court decision in SEC v. Edwards, that involved contracts related to pay phone leases and leasebacks and management rights. And those pay phones would have been -- the payouts would have been dependent on how the pay phone location was operating. And it may have been framed in terms of an interest rate, but they were not buying a

common unit of stock or anything resembling a stock other than it was an investment contract.

There have been other cases dealing with whiskey casks and, you know, animal breeding, et cetera, that are cited in our complaint where the measure of profits varies from one investor to the next.

In terms of the sharing of profits and risks, the second component of horizontal commonality, all that needs to be shown is that all investors shared in the profits and risks 03:47 of the DrafKings Marketplace. And this is established when the fortunes of each investor is tied to the success of the overall venture. It can occur when the enterprise depends on new money coming in, when a portion of the revenue is used to support the enterprise, and in the digital asset context when the success of the digital asset is tied to the success of its underlying infrastructure.

And on this point, I need to take a detour. Dapper Labs did involve NBA moments, not dissimilar to some of the sports NFTs at issue here. And defendants argue, well, that 03:48 case was really predicated on the fact that there was also this blockchain that Dapper Labs had created and that the promoter wanted the blockchain to succeed and one way it could get the blockchain to succeed was by only authorizing the sale of NBA moments on that blockchain.

It's the same situation here. The only difference is

DraftKings is not using a blockchain, it's using the Marketplace. A blockchain is a ledger, if you will. There can be a public blockchain where computers -- no one picks who's verifying transactions -- verifies and records the transactions in the ledger, and then there can be a private blockchain where one entity controls the ledger using block chain technology.

Here, there was a centralized ledger, not unlike a private blockchain. It may not have operated on blockchain technology, but the DrafKings Marketplace alone and its

03:49 personnel were the ones who verified the transactions between DrafKings Marketplace participants. And so the success of the DrafKings Marketplace and the individuals involved in promoting the DrafKings Marketplace depended entirely on the success of the ecosystem, just like the success of the investors depended entirely on the success of the DrafKings Marketplace ecosystem.

So we would respectfully submit that that is a substance over form issue, where defendants are trying to distinguish themselves from Dapper Labs by saying that involved a private blockchain, but it's really the same thing.

03:49 THE COURT: So, I guess, counsel -- and I suspect you're moving on to the last prong of Howey. I guess I would like the best articulation from you of what the expectation of profits was.

MR. FATA: Yes, your Honor.

The expectation of profits, as alleged in the

complaint and that I discussed earlier when I began the argument, was that of capital appreciation, by being able to sell NFTs in the DrafKings Marketplace mandated secondary market, the DrafKings Marketplace.

And that expectation of profits is alleged in at least four ways in the complaint. First we have a structure where DraftKings set up its own securities system where it would be the, you know --

THE COURT: So a closed market, basically.

03:50 MR. FATA: Correct.

THE COURT: Okay.

MR. FATA: It set up its own system where it would be the initial public offerer of the securities, and then it would set up a secondary market exchange for those securities, the DrafKings Marketplace.

So that structure, that twofold structure in and of itself gives investors a reasonable expectation of profits from capital appreciation. They can buy them in the initial public offering and then those that don't do -- those that gain money,

03:51 they can, as Mr. Kalish said, keep their open market profits, and that's paragraph 112.

And that leads to the second type of allegation. Beyond the structure, we do allege statements like Mr. Kalish's in which he states that you can keep the open market profits. I won't rehash that anymore.

THE COURT: Okay.

MR. FATA: The third point, your Honor, expectation of profits, and the courts vary on what they -- they don't vary on what they consider, but they have considered a range of facts and factual allegations in looking at this.

So there's media commentary on the DrafKings Marketplace, and as alleged in paragraph 119 in the complaint, one outlet said that the DrafKings Marketplace is a safe option for anyone looking to invest in NFTs.

03:52 Then we have --

THE COURT: And can I rely on that for the purposes of the third prong, where I should be focused on the efforts of the promoter?

MR. FATA: So the third prong -- the third element has two prongs, and the first prong is the expectation of profits --

THE COURT: Yeah.

MR. FATA: -- and the second prong --

THE COURT: Yeah, and as to either, can I rely on

03:52 alleged statements made by people not associated with the defendants?

MR. FATA: Yes, your Honor. The standard is what a reasonable investor would surmise from a situation. Certainly media commentary on the industry would be a factor that the Court could consider, as could investor sentiment.

And here we have investors saying things like, "It's just like stocks, the secondary market is flooded." That's at paragraph 131.

Another at paragraph 131 is, "This is literally the stock market in a nutshell."

And then at paragraph 134, we have, "The Marketplace is like the stock market." And again, that's paragraph 134.

In terms of defendants' statements, we have -- oh, yeah, we have a podcast that Mr. Kalish participated in on May 17, 2022, again, after the announcement of the gamified version that defendants focus on. And Mr. -- the host says, "Some people are saying NFTs were a fad, is anybody writing that the stock market is a fad, because it's getting annihilated."

This is -- and to this statement Mr. Kalish responded to it without saying these are nothing like stocks. He didn't -- he didn't disclaim the connection. Because at the time, and even to a certain extent now, investors were treating NFTs, digital assets, not unlike stocks.

So expectation of profits were clearly there, and, you know, I go back to the point in paragraph 4, at the outset of our complaint, we allege capital appreciation in the DrafKings Marketplace secondary market to be the profit motive.

And then where did those -- where did the -- it has to be expectation of profits second component from the promotional managerial entrepreneurial efforts of the promoter, in this

case DraftKings or the DrafKings Marketplace. And for a variety of reasons, that's where the expectation of profits would come from. And as Judge Marrero stated in the Drapper Labs decision, if Dapper Labs shut down or shut down the marketplace, what would happen to all of these NFTs? They would go to zero.

Your Honor, in this case, it is -- it is at least as strong, if not stronger than what was presented in the Dapper Labs case. And the reason being, DraftKings controlled

03:55 everything. You could only access your viewing rights and transaction rights via the Marketplace. And something that did not seem present in Dapper Labs is DraftKings appears to be the only holder of record publicly on the Polygon Blockchain of the NFTs.

THE COURT: And this is separate and apart from any monies that investors could expect to get from the reignmaking competition? I guess I'm not clear where that fits into your argument.

MR. FATA: So the reignmaking competitions, Reignmaker

03:56 competitions, we allege were promotional efforts to gin up interest in the DrafKings Marketplace.

Theoretically, a user could hold the requisite number of cards -- if they just held one, that wasn't enough; if they just held two, it wasn't enough; but they could hold the requisite number of NFTs and position them for games, assuming

DraftKings, in its discretion, and it retained discretion, decided to host games. They could theoretically win prizes from that -- from that gaming system, if you will. And then at some point they could sell the NFTs and still realize profits in the secondary market or avoid losses in the secondary market.

And the point about the declining prices that DraftKings said would occur throughout the season, as we explain in our response brief, there are many securities that have prices that decline over time, the most obvious of which are options, which have theta or time decay, and the closer an option gets to maturity, the less value it has, less theta value it has, because there's less time to decide whether to exercise the option or not. And it's not dissimilar in this case. That doesn't take it out of the realm of securities, options are securities. It's just simply a reflection of the market may perceive less value for these particular NFTs that qualify for the games, if DraftKings opts to allow games, and as the season gets shorter and shorter, there's less and less opportunity for that -- for winning the prize or participating in the prize.

But nothing in the complaint alleges that all the NFTs or all investors were motivated by the gamification, and nothing in the complaint even alleges that all investors or all NFTs qualified for the gamification, and in fact, they didn't.

And the allegations are perhaps too detailed on that issue, but they go to the point of explaining the stringent requirements for the games and how -- and from that the Court can reasonably infer not all investors or not all NFTs would be eligible to participate in the games.

THE COURT: Thank you.

MR. FATA: Just the last point, on the private right of action under the Exchange Act, we allege that defendants violated Sections 515 and 29 of the Exchange Act, and we would assert that the -- for the reasons explained in our response brief, your Honor, where, as here, Congress has provided a cause of action, unregistered exchange, and a remedy, rescission, rescission set forth in Section 29. It's not the type of implied right of action that defendants are referring to. And for the remainder of that, we will rely on our brief.

And unless your Honor has any more questions.

THE COURT: Okay, thank you.

MR. FATA: Thank you.

THE COURT: Counsel, I'll give you brief rebuttal, maybe a minute or so.

MR. FRAWLEY: I realize we have been here longer than expected, your Honor. I will be very brief.

At the very end of this colloquy, my colleague described the Reignmaker NFT, I submit, exactly as Mr. Kalish did in the reference that was made in paragraph 112 of the

complaint. He said that a Reignmaker NFT owner could use the NFT in a contest to win prizes and still sell the NFT on the market and cut their losses or get gains. That's exactly what Mr. Kalish said. He didn't say you were going to make a profit, he just said you -- the question was put to him: Do you own the NFT? He said, Yes, you do. You can still use it to get prizes and you can still transfer it if you wish.

Your Honor asked several times of my colleague, like, what the promises were, and I submit the only answer that came out of that colloquy was paragraph 112, one statement in three years that doesn't even say what the plaintiff says it says, but let's assume it does. The test is whether or not the item was promoted primarily as an investment. That's the 2nd Circuit case in Aqua Water, I believe it's called, but it's in our brief. Certainly one oral comment on a blog in three years doesn't qualify.

My colleague also read to the Court paragraph 122 of their complaint where someone else said to Mr. Kalish, Are NFTs -- didn't say DraftKings NFTs -- a fad, is the stock market a fad? This is what the complaint says Mr. Kalish responded: "I think the general idea is that if you hear a marketing message that is related to returns that obviously doesn't make sense, then it's a Ponzi scheme. Just don't put yourself in that position. Just don't do it. Do it from the mindset, you know, it's going to be bad in the end."

My colleague also referred on the same subject, frankly, to SG Ltd. as a 1st Circuit case about an online game. What the 1st Circuit said it was was a Ponzi scheme and that horizontal commonality was established because the entity was washing money off of new investors to pay old investors, the online game was fake, but the purchasers acquired stock in the fake company. So that was the proportionate interest in the gains and losses of the fake company that gave them the pro rata interest that's entirely absent here.

04:02 There was also a lot of, frankly, confusing discussion about what the complaint says and mixing and matching concepts here this afternoon. But one of the other themes that I think is important here is the 1st Circuit also said in SG Ltd. that it's important for capital markets that there be clear and understandable rules as to what constitutes a security. I submit to you what the plaintiffs propose here are neither clear nor understandable.

The last, the plaintiffs suggested that we made up the argument about whether or not or what DraftKings was going to

04:02 do with --

(Phone ringing.)

MR. FRAWLEY: Very sorry, your Honor.

THE COURT: No worries.

MR. FRAWLEY: -- that DraftKings made up what was going to happen with the revenues. And the opposition at page

1, the complaint at page 44 says that DraftKings does what it wishes with the NFT proceeds, including keeping profits for itself or using it elsewhere in DraftKings' business.

And the last point -- actually, two very quick points, your Honor. The plaintiffs protested that any large company could avoid the registration requirements because they're large. But that's not the issue here. The issue is all of the cases that the plaintiff relies upon there was a company with a singular business that used some alternative form of raising capital for the benefit of the business just like an equity offering, they just didn't call it that, whether it be orange groves or chinchillas or whiskey casks, all the same thing, pay telephones, somebody used an asset to raise capital for investment. That's not what happened here.

The last point is your Honor asked about the declining value of the Reignmaker NFTs, and my colleague said that doesn't matter, some securities decline in value. Well, it does matter. This isn't some security, it's an investment contract, the premise of which is there has to be a promise that it's going to increase in value. The only promise that was made here is that they were going to decrease in value.

And for that reason as well, your Honor the motion should be granted.

I very much appreciate your time.

THE COURT: Thank you.

Counsel, I appreciate the arguments on either side. As hopefully my questions to both sides suggested, I've been thinking about this; I need to give it some more thought.

Counsel, you're not making my job easy but that's for me to deal with. I appreciate the arguments on either side and I'll take the matter under advisement and we'll go from there. Thank you.

THE CLERK: All rise.

(Court adjourned at 4:05 p.m.)

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CERTIFICATION

I certify that the foregoing is a correct transcript of the record of proceedings in the above-entitled matter to the best of my skill and ability.

/s/Debra M. Joyce
Debra M. Joyce, RMR, CRR, FCRR
Official Court Reporter

January 9, 2024
Date